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No. 94-1229

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

JOSEPH P. CAULFIELD,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Supreme Court
From the United States Court of Appeals for the Eighth Circuit

PETITIONER'S REPLY BRIEF

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QUESTIONS PRESENTED

1. Whether the Eighth Circuit United States Court of Appeals has erred by rendering a decision in conflict with the decision of another United States Court of Appeals on the same matter?

2. Whether the Eighth Circuit United States Court of Appeals has decided an important question of Federal law, which has not been, but should be settled by this court?

3. Whether the Commissioner of Internal Revenue exceeded the authority granted by the United States Congress by arbitrarily assessing additional liability to a taxpayer for negligence penalties under I. R. C. §6653(a)(1) and 6653(a)(2), and additions to tax under I. R. C. §6661 by arbitrarily assessing additional liability to a taxpayer for understatement of income when taxpayer has demonstrated good faith?

4. Whether records, accepted by the Commissioner of the Internal Revenue as adequate in one year, can be deemed inadequate in other years, when records are kept in the same manner?

5. Whether the Commissioner of the Internal Revenue exceeded the authority granted by the United States Congress by arbitrarily reconstructing a taxpayer's income?

6. Whether the Commissioner's assessment was entitled to a presumption of correctness when it is demonstrated that there were substantial errors and nontaxable income was included?

7. Whether the Commissioner of Internal Revenue exceeded the authority granted by the United States Congress by arbitrarily designating bank loans as taxable income and whether a loan, however named or labeled, can be included as taxable income?

8. Must the Commissioner investigate sources of nontaxable income under *Holland v. United States*, 348 U. S. 121, 75 S. Ct. 127, 99 L. Ed. 2d 150 (1954)?

9. Did the Tax Court err? Must the Commissioner make prima facia showing of negligence, before the burden is placed on the taxpayer to disprove the negligence?

LIST OF PARTIES

The petitioner is Joseph P. Caulfield.

The respondent is the Commissioner of Internal Revenue.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
LIST OF PARTIES	iii
TABLE OF CONTENTS	v
TABLE OF AUTHORITIES	vi
STATEMENT OF JURISDICTION	1
CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	2
ARGUMENT	6
CONCLUSION	10
CERTIFICATE OF SERVICE	10

TABLE OF AUTHORITIES

Page(s)

Cases:

Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 207 (1990) 9

Commissioner v. Tufts, 461, U.S. 300, 307 (1983) 9

Cummings v. Commissioner, 410 F. 2d 675 (5th Cir. 1969) 7

Dodge v. Commissioner, 981 F. 2d 350 (8th Cir. 1992) 7

Holland v. United States, 348 U.S. 121, 132, 135-36, 75 S.Ct. 127, 135, 99 L.Ed.2d 150 (1954) ii,7

Norgaard v. Commissioner, 939 F. 2d 874, 879-880 (9th Cir. 1991) 9

Portillo v. Commissioner, 988 F.2d 27 (5th Cir. 1991) ... 8

Schwartzkopf v. Commissioner, 246 F. 2d 731, 733-734 (1957) 7

Singleton v. Wulff, 428 U.S. 106, 121, 96 S. Ct. 2868, 2877, 49 L. Ed. 826 (1976) 6

United States v. Janis, 428 U.S. 433 (1976) 7

Weimerskirch v. Commissioner, 596 F. 2d 358, 361 (9th Cir. 1979) 7

Internal Revenue Codes:

I. R. C. §446(b) 7

I. R. C. §6653 3,4,5

I. R. C. §6661(a) 3,4,5

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PETITIONER'S REPLY BRIEF

STATEMENT OF JURISDICTION

The jurisdiction of the Tax Court was proper pursuant to I. R. C. §6213 and I. R. C. §7442.

Appellate jurisdiction for the United States Eighth Circuit Court of Appeals is based on I. R. C. §7482(a). Entry of Judgment was made by the United States Court of Appeals on August 29, 1994. Appendix B. Appellant's Petition for Rehearing was denied by the United States Court of Appeals on October 19, 1994. Appendix C.

Jurisdiction of this Honorable Court is invoked pursuant to Supreme Court Rule 10, Paragraphs A and C.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

1. Article 1, Section 8, paragraph 18 of the United States Constitution provides that: "The Congress shall have power . . . To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof."

2. Amendment I of the United States Constitution provides that: "Congress shall make no law . . . prohibiting the free exercise . . . to petition the Government for a redress of grievances."

3. Amendment VIII of the United States Constitution provides that:: ". . . nor excessive fines imposed . . ."

4. Amendment IX of the United States Constitution provides that: "The enumeration in the Constitution, of certain Rights, shall not be construed to deny or disparage others retained by the people."

STATEMENT OF THE CASE

This action challenges the constitutionality of the Commissioner of Internal Revenue's authority to arbitrarily reconstruct a taxpayer's income and the extent to which the Commissioner may err to lose the presumption of correctness that normally attaches to an assessment pursuant to I. R. C. §6001 Treas. Reg. §6001-1(a); and asks this Court to clarify the conflict in the decisions rendered between the different circuits of the United States Court of Appeals.

The Eighth Circuit interpretation of the Commissioner of Internal Revenue's authority pursuant to I. R. C. §6001. Treas. Reg. §6001-1(a).

The Commissioner of Internal Revenue's arbitrary authority to designate "Bank Loans" as taxable income. The Commissioner of Internal Revenue's arbitrary authority to assess additional liability under I. R. C. §6653(a)(1) and 6653(a)(2), and substantial understatement of income under I. R. C. §6661, when the taxpayer has demonstrated a good faith effort.

The Eighth Circuit interpretation of the Commissioner of Internal Revenue authority pursuant to I. R. C. §6653(a)(1), 6653(a)(2), and I. R. C. §6661.

The Eighth Circuit interpretation as to the extent an issue must be raised to be preserved for an appeal.

Joseph P. Caulfield petitioned the Tax Court to redetermine the tax deficiency set forth in the notice of deficiency. The Tax Court sustained the deficiency against Mr. Caulfield. The Petitioner timely appealed to the Eighth Circuit Court of Appeals on September 12, 1994. The Eighth Circuit upheld the decision of the Tax Court. A Petition For Rehearing was filed, but denied by the Eighth Circuit on October 19, 1994.

The Petitioner was engaged in the business of being a public insurance adjuster. Mr. Caufield filed his U.S. Individual Income Tax Return Form 1040, for the taxable years 1982 and 1984 with the Internal Revenue Service located in Kansas City, Missouri.

The Commissioner of Internal Revenue mailed a notice of deficiency to Mr. Caulfield dated October 13, 1988. The Commissioner determined that Mr. Caulfield's records were inadequate for the years 1982 and 1984. The Commissioner reconstructed Mr. Caulfield's income for those years using the bank deposits plus cash expenditures method. Based on this reconstruction, the Commissioner assessed taxes and penalties for 1984 and 1982 as follows:

Year	Deficiency	§6653(a)(1)	§6653(a)(2)	§6661
1982	$21,974.00	$1,099.00	50% of the interest on $21,947.00	--
1984	$15,949.00	$797.00	50% of the interest on $15,949.00	$3,987.00

Petitioner has contended that the Commissioner overstated the amount of nondeductible expenditures in the form of personal living expenses and capital expenditures, thereby erroneously increasing the unreported income computed under the bank deposits method. One of the capital items was a Camero purchased for the price of $11,318.00 in 1982. Mr. Caulfield maintained that he did not buy the item outright but that he financed the purchase. At trial before the Tax Court, the Petitioner was unable to locate the loan contract. It was subsequently located among papers returned by the Commissioner.

The Commissioner's recomputation of the Petitioner's income also failed to take into account the fact the he had nontaxble funds including loan proceeds, bank transfers and a considerable understatement of the opening balance in Petitioner's various bank accounts.

The Tax Court concluded that the Commissioner had made several errors in the calculations but it determined that these errors were not of such magnitude so as to conclude that the Commissioner's assessment was arbitrary. Further the Tax Court did not require the Commissionr to seek out information concerning the source of nontaxbable income. The Tax Court instead placed the burden on the Petitioner to establish that he had no nontaxable sources of income.

The Petitioner has urged that the Commissioner should not have reconstructed his income because his records were complete. The Petitioner has also contended that the imposition of penalties was unfair, burdensome and excessive in this case because he made a good faith effort to fully account for and believes that he did report all of his income.

The Eighth Circuit held that the Petitioner did not properly preserve the issue of the adequacy of his records and that even if the issue had been properly preserved it found that the reconstruction of Petitioner's income was appropriate because the records were only complete on their face.

The Eighth Circuit also determined that the Tax Court's findings regarding the assessments were not clearly erroneous and that the Commissioner 's reconstruction of Petitioner's income was entitled to a presumption of correctness despite the numerous errors made by the Commissioner. The Eighth Circuit sustained the imposition of penalties under Sections 6653 and 6661 of the Internal Revenue Code.

ARGUMENT

The Petition for Writ of Certiorari was submitted to this Honorable Court for a determination of several important issues. Among them is the issue of whether it was proper for the Commissioner to reconstruct the Petitioner's income after accepting the Petitioner's same record-keeping methods in prior years. There is also an important issue whether the Commissioner's assessment was so flawed so as to preclude the Commissioner from gaining the benefit of a presumption of correctness. Because of the many errors and the Commissioner's reliance on the faulty assumption concerning the car loan, the Petitioner urges that the assessment should not have been entitled to the presumption of correctness usually afforded a sound assessment. In Petitioner's case, the court erred in determining that the Petitioner had not raised the issue of the adequacy of his records. Petitioner did not focus on the adequacy issue but he did not ignore it. The Tax Court stated that the Petitioner did not "seriously question" the Commissioner's authority to reconstruct his income. This statement indicates the extent to which the Petitioner raised the adequacy issue and does not bear on whether the Petitioner raised the issue.

Not only was the issue raised by the Petitioner, but the issue was raised by the Commissioner and the Tax Court was, therefore, fully aware of it and it was not unfair surprise to the Commissioner because they have had fair chance to address it. In *Singleton v. Wulff*, 428 U. S. 106, 121 1976) this Court recognized that there may be exceptions to the rule such as "where the proper resolution is beyond any doubt . . . or where 'injustice might otherwise result'." The Petitioner believes that there are limits on the Commissioner's authority to reconstruct income. There is no indication in this case that the Petitioner's records were inadequate or inaccurate. To extend the Commissioner's authority to reconstruct a taxpayer's income where records were complete would give the Commissioner

authority far beyond that contemplated by our tax laws. It is important that the Court make a determination on this issue.

Beyond question, where no adequate records are present, the Commissioner may reconstruct taxable income by any reasonable method. I.R.C. § 446(b), *Dodge v. Commissioner*, 981 F. 2d 350 (8th Cir. 1992). Or, as the Eighth Circuit explained in the Petitioner's case, when a taxpayer keeps books and records that on their face are consistent with and support a return as filed, the Commissioner may determine the taxpayer's income through indirect methods. *Holland v. United States*, 348 U.S. 121, 132 (1954); *Schwartzkopf v. Commissioner*, 246 F. 2d 731, 733-734 (1957). However, these cases and the Eighth Circuit' determination in this case do not address the issue of Mr. Caulfield's case; whether once the Commissioner has accepted a taxpayer's records as adequate in one year may she then not accept the same records as adequate in another year, *Presumption of correctness issue.....*

The Petitioner contends that the Commissioner's arguments set forth in her Reply are faulty. They do not coincide with the facts of this case, and understate the importance of the issues involved.

Prevailing law does affirm that the Commissioner's method of calculating income is usually presumptively correct. *United States v. Janis,* 428 U.S. 433, 441 (1976). Too, the Commissioner is correct in stating that mathematical exactitude is not required. *Dodge v. Commissioner,* 981 F.2d 350, 353 (8th Cir. 1992), *cert. denied,* 114 S.Ct. 58 (1993). However, the Commissioner does not have 'carte blanche' and her assessment must be rational. See *Cummings v. Commissioner,* 410 F.2d 675, 679 (5th Cir. 1969). See also *Weimerskirch v. Commissioner,* 596 F.2d 358 (9th Cir. 1979).

In this case the assessment was arbitrary because the Commissioner treated the purchase of the Camero as if it had been

deducted as a nontaxable loan. There is however, no indication that this was done.

The Camero was purchased on December 27, 1982. The Commissioner's position on the contract is that it is immaterial because the amount was deducted from her calculation as a nontaxable loan in the amount of $10,000 dated December 20, 1982. The Petitioner argues that the amount was not deducted because the Commissioner merely assumed that a loan was made for the purpose of purchasing the Camero. The Commissioner had no evidence whatsoever to have concluded that these amounts were one and the same. The $10,000 was another loan. This was only an assumption on the Commissioner's part. There is absolutely no basis for that assumption and it illustrates the problems with the reconstruction of the Petitioner's income. In *Cummings*, the Commissioner reconstructed the taxpayer's income without the aid of any information other than bank records for certain years and used the bank deposits computation method. The Commissioner had access to bank records for 1956-1958. The Commissioner applied average net profits for 1956-1958 to deposits for the years 1944-1955 to determine annual income. The Court held that although that taxpayer had failed to keep the necessary records, the Commissioner was not entitled to the presumption of correctness. It was arbitrary for the Commissioner to have applied the 1956-58 average to the 1944-55 calculation.

In *Portillo v. Commissioner,* 932 F.2d 1128 (5th Cir. 1991) the taxpayer, Portillo, a self-employed painting subcontractor was audited by the Internal Revenue Service. The IRS issued a notice of deficiency based on a Form 1099 submitted by Portillo's contractor. The 1099 Form showed a larger amount of income than had been reported by Portillo on his 1040 Form. The IRS failed to substantiate the accuracy of the 1099 Form before issuing the deficiency. The court found that the unsubstantiated and unreliable Form 1099 was insufficient to form a rational foundation for the tax assessment. *Id.* at 1133.

In Petitioner's case, the Commissioner merely assumed that she had subtracted the car loan proceeds without substantiating that the December 20th loan was used to purchase the Camero.

Because the Commissioner was operating under false assumptions, regarding the deduction of the $10,000 loan, nontaxable loan proceeds were treated as income. This is directly contrary to this Court's holdings in *Commissioner v. Tufts,* 461 U.S. 300, 307 (1983) and *Commissioner v. Indianapolis Power & Light Co.,* 493 U.S. 203, 207 (1990).

The Petitioner believes that he acted in good faith and made an honest attempt to report his income. The Commissioner has made no showing that the Petitioner was negligent in reporting his income. The Petitioner keeps his records accurately to the best of his ability. Every dollar that Mr. Caulfield received was dutifully recorded. Every check received as a commission from insurance companies is routinely copied and recorded. It is possible, however, that some checks are copied but unintentionally not recorded. Everyone, no matter how diligent, can make a mistake but that is not negligence. In *Norgaard v. Commissioner,* 939 F.2d 874 (9th Cir. 1991) the taxpayer gambled and the method he used for determining his winnings entailed keeping all cash won and losing tickets in a brown bag. If at the end of the year, cash remained in the bag, he would count it and report his winnings. The method was determined to be inaccurate but since reasonably calculated to record income, it was approved by the court. The court in *Norgaard* recognized that a taxpayer however diligent, may fail to catch some income. As long as the taxpayer has used a reasonable method to record income then the taxpayer will not be considered negligent. This is not what the Eighth Circuit held and therefore Petitioner's case and that of *Norgaard* are in conflict with each other.

CONCLUSION

For these reasons the Court should grant this petition for certiorari and, upon review, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the foregoing was mailed to Gary R. Allen, Richard Farber, William J. Patton, and Loretta C. Argett, Department of Justice, P.O. Box 502, Washington, D.C., 20040, first class postage prepaid, this 13th day of March, 1995

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